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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE REVIEW AND POSSIBLE REVISION OF ARIZONA UNIVERSAL SERVICE FUND RULES, ARTICLE 12 OF THE ARIZONA ADMINISTRATIVE CODE.	Docket No. RT-00000H-97-0137
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS.	Docket No. T-00000D-00-0672

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the Rejoinder Testimony of Dr. Ben Johnson in the above-referenced matter.

RESPECTFULLY SUBMITTED this 5th day of March, 2010.

Michelle Wood
Counsel

Arizona Corporation Commission
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REJOINDER TESTIMONY

OF BEN JOHNSON, PH.D.

On Behalf of

THE STATE OF ARIZONA

RESIDENTIAL UTILITY CONSUMER OFFICE

Before the

ARIZONA CORPORATION COMMISSION

Docket Nos. T-00000D-00-0672 and RT-00000H-97-0137

Introduction

Q. Would you please state your name and address?

A. Ben Johnson, 3854-2 Killearn Court, Tallahassee, Florida 32309.

Q. What is your present occupation?

A. I am a consulting economist and president of Ben Johnson Associates, Inc., an economic research firm specializing in public utility regulation.

Q. Are you the same Ben Johnson that filed direct testimony in this proceeding on January 6, 2010?

A. Yes, I am.

Q. Did you file reply testimony on February 5, 2010 in this docket?

A. No, I did not. The filing date for Staff and RUCO's first round of testimony was on January 6, 2010, more than a month after all other parties filed their direct testimony. Between January 6 and February 5, no additional testimony was filed which could serve as the basis for my reply testimony. In the interest of conserving resources, I decided to wait until this filing date to file additional testimony, which gave me the opportunity to respond to the testimony filed on February 5.

Q. What is your purpose in making your appearance at this hearing?

A. Our firm has been retained by the Residential Utility Consumer Office ("RUCO") to assist with RUCO's participation in this generic proceeding to investigate the pricing of intrastate switched access service, including proposals to reduce access rates by increasing local rates, and/or expanding the Arizona Universal Service Fund ("AUSF"). In this testimony I respond to some of the points raised in the reply testimony of Staff witness Wilifred Strand, Verizon witness Don Price, AT&T witness Debra Aron, and ALECA witness Douglas Meredith. The fact that I do not respond to certain issues raised by the other witnesses in this proceeding should not be construed as my acceptance of their positions on those issues.

Q. Let's start with Staff witness Wilifred Strand. What portion of his reply testimony do you wish to address?

A. I would like to briefly comment on his concerns regarding my proposal to make AUSF support portable between carriers. As I explained in my direct testimony, AUSF support should not necessarily be limited to the incumbent carrier. Rather, support should be readily transferable from one carrier to the next, if a customer in a high cost area changes carriers. Mr. Strand noted such an approach would be "theoretically attractive". However, he is concerned that it would "suffer from some practical shortcomings". [Strand Reply, p. 4]

> ETC support for each state was capped [by the FCC] at the level of support that competitive ETCs in that state were eligible to receive during March 2008 on an annualized basis. Further, portability from Staffs perspective means that as a customer changes carriers, the support that follows the customer to the new carrier would be offset by an equivalent reduction in the support provided to the carrier that loses the customer. Staff does not believe that such a provision can be implemented absent the processing of an R14-2-103 filing by a company. [Id.]

I agree that there are practical, logistical and legal issues that would need to be resolved before implementing any changes to the AUSF. However, such issues need to be resolved in any event, and they do not arise simply due to my recommendation that support be portable. Admittedly, these issues might be more complex if the Commission allows other carriers to participate in the AUSF. Making the AUSF competitively neutral is a fairer, more theoretically sound approach, which offers significant public policy benefits which justify the additional effort involved in resolving the associated implementation issues.

I would also note that the cap referenced by the Staff witness is a constraint on CLEC federal support. The cap on federal support should not preclude adopting a policy of transferability for state universal service support. In any event, there is no need to decide at this juncture exactly what approach should be used – if the Commission concludes that changes are warranted to the current arrangements, it should probe into the issues further, and evaluate the pros and cons of various approaches, before moving forward with implementing any changes.

Finally, I would note that, in principle, AUSF support that follows the customer to a new carrier <u>should</u> be offset by a reduction in the support received by the carrier that loses the customer. This is what happens in a normal competitive marketplace, where a firm that loses market share experiences a reduction in its revenues, forcing it to cut costs and increase efficiency. Unless a similar mechanism is adopted by the Commission, AUSF support will be viewed as an "entitlement" by the incumbent carriers, reducing their incentives to operate efficiently, and increasing the danger of the fund growing to the point where it imposes an unreasonable burden on customers located in the urban parts of the state.

As I explained in my direct testimony, the potential burden will be particularly severe if payments from the fund are based upon the incumbent's embedded costs. If the AUSF is tied to embedded costs, as the incumbent LEC's market share declines, its embedded investment and other fixed costs will be spread over fewer lines. This would increase its embedded cost per-line, potentially increasing its per-line draw from the AUSF. If other carriers also draw from the AUSF based upon the embedded cost per-line of the incumbent, their funding amount will increase even more rapidly (as they receive an increasing amount per line multiplied times an increasing number of lines), and the total size of the fund will escalate.

The potential for the AUSF to impose an unreasonable burden on urban customers will vary depending on various aspects of the support mechanism. For instance, if an economic cost modeling approach is used, rather than an embedded cost-based methodology, the risks are reduced, since the Commission can readily determine the extent to which economies of scale should be reflected in the AUSF calculations. Initially, economic costs could be developed based upon the assumption of a single hypothetical network serving 100% of the customers. If competition develops in rural areas and market shares decline, the Commission can determine whether it should continue to use this hypothetical 100% market share assumption, ("as if" the modeled carrier serves the entire market), or whether it should modify the cost analysis to reflect a lower assumed market share which reflects less extensive economies of scale (e.g. "as if" the modeled carrier serves 80% of the market). This flexibility in varying "what if" assumptions is one of the inherent advantages of an economic cost model. Another key aspect is the benchmark mechanism which is used, and in particular, the extent to which carriers will be required to recover some of the high costs of serving rural areas from sources other than the

AUSF – for instance, from the rates they charge their retail customers, from the federal high cost support mechanism, and from rates charged for internet access and other unregulated ancillary services which are provided by using many of the same network facilities used in providing basic local service.

Q. Let's turn to the reply testimony of Verizon witness Don Price. What issue raised in his testimony would you like to address?

A. I would like to briefly respond to his comments about recovery of loop costs. In my direct testimony, I stated that the entire cost of the access line should not be recovered from the particular end user who requests installation of the line. In response, Mr. Price notes that Verizon "has proposed that the Commission utilize Qwest's current intrastate access rates as the benchmark for the ALECA members". [Price Reply, p. 49] Mr. Price further explains:

> The Qwest intrastate access rates are set well above economic cost, meaning that those rates contain a contribution toward joint and common costs, including the cost of the local loop. So leaving aside any disagreement I might have with Mr. Johnson's cost allocation theories, the Commission need not be concerned with the scenario Dr. Johnson portrays. [Id.]

I would note that this proceeding doesn't include any cost studies or detailed information concerning the allocation methodologies supporting Qwest's intrastate access rates, and thus it isn't feasible to determine what share of Qwest's joint and common costs are being recovered in its current switched access rates. But, one thing is clear – Qwest's costs are primarily incurred within the state's urban areas, whereas the focus of this proceeding is on the State's rural areas. Since per-line costs are higher in rural areas than in urban areas, it is clear that whatever percent share of joint and common costs is being borne by Qwest's intrastate access rates, a much smaller share of the analogous costs of rural carriers would be borne by those same rates if they were applied to smaller carriers operating exclusively within the rural parts of the State. Stated another way, by applying Qwest's access rates to rural carriers, the share of their loop costs which will be recovered will be substantially less than the share of loop costs which is recovered by Qwest when charging those same per-minute rates in Phoenix and Tucson.

Q. Let's now discuss the reply testimony of AT&T. What issues would like to address?

A. I would like to respond to several comments made by AT&T witness Debra Aron. Specifically, I would like to address Dr. Aron's comments regarding the possible effects of rate increases on universal service; her comments regarding the proper recovery of joint and common costs; her contention that access charges have not been an effective tool for recovering a portion of network costs, including joint and common costs; and, the impression she seems to have that I am recommending a regulatory system which favors new entrants at the expense of established carriers.

Q. What does Dr. Aron have to say about universal service and subscriber penetration rates?

A. In response to my concerns about the possible negative impact of increased local exchange rates on universal service, Dr. Aron states:

> [W]hile the potential effects of retail price increases on overall telephone penetration is certainly an issue that regulators must attend to, the evidence suggests that at least some increase in retail rates is tolerable. Dr. Johnson's testimony fails entirely to recognize that 97 percent of the population in Arizona over the age of 15 has a wireless phone, and that the wireless, wireline, and VoiP networks are interconnected; and fails to appreciate the implications of these 21st century realities for universal service. As I discussed in my Direct Testimony, even if increasing retail wireline prices caused some customers to drop their wireline telephone service, this would not necessarily have any effect at all on universal service or telephone penetration if those customers choose to rely on other technologies to meet their communications needs. Only to the extent that price increases cause customers to drop their wireline phone and to not subscribe instead to cable telephony, wireless, or some other form of telephony, would retail rate increases possibly impact goals of universal service.

> Nevertheless, it is certainly reasonable to advise the Commission to "think through the consequences" of reducing access rates and develop a plan to minimize any potential adverse consequences. [Aron Reply, p. 78]

Dr. Aron seems to be suggesting that decreased landline subscribership doesn't matter, since alternative means of communication exist. However, Dr. Aron has glossed over the inherent differences between wireline service and "alternatives" such as wireless and VOiP service. For most customers, wireless (and VOiP) services primarily function as complements to wireline service, rather than direct substitutes. For instance, some customers may purchase wireless service for use while driving around the state, or when visiting the nearby towns and cities, even if they live in a remote area where the wireless carrier's call quality is grossly inferior to that provided by the regular phone line. There is no evidence in this proceeding concerning call quality in specific locations within the state, or the extent to which wireless and broadband alternatives are available in various parts of the state, or the prices that are charged for these other services. Absent more evidence concerning these issues, the Commission should not assume that the universal service goal could be maintained even without the state's rural wireline carriers.

Q. What are some of the important differences between wireline service and alternatives like wireless and VOiP?

A. First, there are significant differences in the way these services are priced. Wireless and VoiP services typically are provided as a package offering which includes various enhanced services and long distance services. As a result, they are generally priced far higher than incumbent's stand alone basic exchange service. Further, wireline services are typically priced on a flat fee (unlimited local usage) basis. Wireless services, on the other hand, are typically priced on a monthly volume of calling basis. The more you expect to use the phone, the more you can expect to pay for wireless service – either because of per-minute charges or because of the need to purchase a pricing plan with a large bundle of minutes. The pricing structure of wireline services typically allows users to pick up the phone as often as they want, and allows them to talk to others in their local calling area as much as they want, without having to be concerned they might receive a large bill at the end of the month. In contrast, the wireless industry continues to price its services with respect to anticipated usage levels. Because of consumer preferences, there has been a strong trend away from pure per-minute pricing of wireless services, toward "bundled" pricing. Yet, even with the decline in per-minute costs resulting from increased economies of scale and favorable trends in technology, the wireless industry continues to price most of its offerings on the basis of different levels of anticipated usage.

Another important consideration when comparing wireless service to wireline and VoiP service is the quality of the calls that can be placed on each. Wireline services typically provide higher quality, more reliable communication than these alternatives. Calls placed over land lines are typically dropped less often than calls placed over wireless facilities. Further, land line calls are less subject to weather interference; they are not subject to structural interference; they are less subject to congestion problems; they are less frequently subject to cross talk; and, they are less frequently subject to static, noise, fading, and other aspects of poor sound reproduction. Although wireless service offers the advantage of greater mobility, it does not serve a close substitute for wireline consumers who care about having consistently accurate, noise-free sound reproduction. Given a choice between pulling a cell phone out of their pocket or walking across the room to use a conventional phone, consumers will often choose the latter option because of these differences in sound quality and reliability.

Just as postal service, overnight delivery services, and email service all serve as occasional alternatives to wireline phone service, a limited degree of substitution between wireless and wireline services have always occurred in practice, at least at the edges of the market (for certain customers and certain situations). Although the minority of people who have abandoned wireline service in favor of wireless or VOIP services is increasing, wireless and wireline services have always been, and to to a great extent continue to be, complementary services, rather than close substitutes. While exact comparisons are difficult to make, because of the many differences between wireless and wireline services, it was (and is) obvious that the Commission cannot simply ignore the public policy benefits of offering universally available, reasonably priced wireline local service throughout the state – nor can the Commission assume that wireless or broadband cable service will provide an adequate, cost-effective alternative to traditional basic local exchange service in rural areas. Thus, it is reasonable to continue to provide support for the high cost of providing that service – through intrastate access charges, the AUSF, or (preferably) a combination of the two.

Q. Hasn't AT&T proposed a graduated implementation of local exchange rate increases?

A. To a certain extent. As explained by Dr. Aron:

> AT&T proposed to reduce intrastate access rates to interstate rates immediately, but phase in price increases over time to replace that revenue by setting a maximum annual price increase. The forgone revenue that is not recovered through the annual increase would be replaced with AUSF funds in the short run, but the AUSF support would be decreased and the retail price would be increased until it reaches an established benchmark over a measured period of time (for example, two years) to minimize rate shock. Such a plan would provide Arizona long distance customers with the benefits from reduced access rates immediately, would reduce incentives for arbitrage, and would decrease the distortions to intermodal long distance competition, while phasing in the necessary retail rate increases over time and to a level that the Commission considers acceptable and consistent with universal service goals. This plan meets Dr. Johnson's objectives of increasing efficiency (by decreasing access rates right away) while moving slowly and deliberately on retail price increases that he believes could reduce telephone penetration. [Id., p. 79]

I agree that phasing in any allowed price increases would help avoid the risk of rate shock and ameliorate the potential for price changes leading to reduced subscriber penetration. As well, to the extent access charge reductions are passed through to customers in the form of dollar-for-dollar reductions in retail intrastate long distance rates in the state, the resulting reduction in phone bills will also serve to ameliorate the impact of higher local rates to some extent. However, AT&T hasn't provided sufficient assurance that if it obtains the access charge reductions it is requesting, those reductions will, in practice, be fully passed-through to retail long distance customers in the state. Nor is there any reason to assume that the long distance market is sufficiently competitive to ensure an immediate, dollar-for-dollar reduction in retail long distance rates. Absent a specific, enforceable promise to pass through any rate reductions, a decision to reduce access rates and increase local rates will not necessarily leave retail customers whole – the overall net impact may be to shift money from the bank accounts of the state's retail customers, to the accounts of its telecommunications carriers.

Q. What does Dr. Aron have to say about the proper recovery of joint and common costs in the context of access charge reform?

A. In my direct testimony, I explained that for more than 30 years, AT&T and other long distance carriers have been arguing, in various ways and various forums, that they should be allowed to use the local networks without paying anything for this privilege. In response, Dr. Aron states:

> AT&T is proposing to pay rates that by all evidence exceed the ILECs' costs of providing switched access service to AT&T. ... The cost associated with switched access is the cost of switching and associated transport, not the cost of the loop. [Id., p. 80]

Dr. Aron has conveniently ignored my discussion of more than 90 years of court decisions and regulatory practice regarding the appropriate recovery of loop costs, and other joint and common costs. As I pointed out in my direct testimony, in 1923 the U.S. Supreme Court, in

Smith vs. Illinois Bell Telephone Company rejected the costing approach preferred by Dr. Aron, in which long distance services are assumed to only be responsible for their direct costs. The Supreme Court concluded that allocating the entirety of loop costs onto intrastate service would result in an "undue burden" on that category of service. The same principle applies within the intrastate jurisdiction, with respect to unduly burdening local exchange service. This principle of fairly distributing the joint or fixed costs of the network to all of the users of the network has been repeatedly applied and upheld since then. Despite continued arguments like the one advanced by Dr. Aron, the policy of spreading these costs across multiple services has been affirmed in numerous proceedings throughout the country. [See, e.g., Johnson Direct, p. 7 et. seq.]

Q. Haven't the interexchange carriers recently had some success with their argument?

A. Yes. The wireless carriers have been successful in persuading the FCC to allow them to access the local networks without paying much, if any, of the joint and common costs of the network, and the interexchange carriers have persuaded the FCC to greatly reduce per-minute interstate access charges, and to adopt various other policies that have the effect of shifting costs onto local customers. While some aspects of those policies may be considered successful at least in some respects, there are other aspects that are problematic. For example, the FCC has been relying on a federal USF mechanism to ameliorate the potential impact on rural carriers and rural customers -- but the federal USF has grown rapidly in size, and the FCC hasn't figured out how to completely solve that problem. It is currently investigating the issue, and is relying on a freeze to constrain the size of the fund.

Q. Can you now discuss Dr. Aron's contention that access charges have not been an effective tool for recovering a portion of network costs, including joint and common costs?

A. In my direct testimony I stated that although the Commission could consider the possibility of deviating somewhat from the status quo, including the level of access charges, I recommend the Commission adhere to traditional cost recovery patterns absent extraordinary circumstances.

In reply, Dr. Aron referred to these cost recovery patterns as a "crumbling and antiquated system of excessive access rates". [Id., pp. 80-81]

> [Access revenues] create a self-reinforcing downward spiral of support for LECs because high access rates force wireline long distance rates up, which makes wireline long distance service less competitive relative to wireless and other technologies that do not pay access rates to the same extent as do wireline IXCs, or do not pay them at all; customers migrate from wireline to other forms of long distance communication; and access revenues dry up for the LECs that they historically supported. [Id., p. 81]

I will acknowledge the the FCC has been expanding the discrepancy between federal and state interconnection compensation policies, which is putting downward pressure on the support local exchange carriers receive from intrastate switched access charges. The FCC has preempted state regulation of wireless and broadband internet access services, and it is allowing wireless carriers to originate and terminate in-state long distance calls on the wireline local exchange networks without requiring these carriers to pay intrastate switched access charges. This has led to pricing practices in the wireless industry which blur the distinction between local and long distance calls. All of these federal regulatory policies are placing downward pressure on intrastate long distance prices and calling volumes.

Due to the pressures exerted by these federal policies, it may be helpful to reduce reliance on switched access rates and to concurrently expand reliance on the AUSF as the primary mechanisms used to support the high cost of phone service in rural Arizona. A shift toward the AUSF would be particularly logical if it is feasible to broaden the scope of the AUSF to include participation from wireless and broadband carriers. If the revenue base of the AUSF were substantially broadened, to include additional carriers and additional services – including both wireless services and internet access services – it would be easier to protect customers from unreasonable increases in basic local exchange rates.

However, I would point out that, in my direct testimony I was not arguing against any changes whatsoever, nor was I opposed to a well-thought-through shift toward greater reliance on the AUSF. Rather, I was arguing that any changes to these support mechanisms need to be carefully planned and researched, and that the burden of proof should lie with the parties advocating the proposed changes.

Q. Can you now discuss Dr. Aron's implication that you are recommending a regulatory scheme that favors new entrants at the expense of established carriers?

A. In my direct testimony I pointed out that the Commission should carefully evaluate the potential consequences of proposed realignments of telecommunications prices at this stage in the effort to transition toward a more competitive market. I also noted that the policy changes being advocated in this case won't necessarily help new entrants gain a foothold in the market, and may hinder further progress towards effective competition. Dr. Aron apparently misunderstood these comments to mean I favored somehow subsidizing new entrants:

> Helping new entrants gain a foothold in the market, is not a valid or responsible public policy goal. Helping new entrants gain a foothold in the market means subsidizing them, protecting them from competition, applying rules unequally to them, or otherwise enhancing their ability to succeed beyond what the quality and costs of their own business can accomplish. Such market intervention is harmful to competition and harmful to consumers. This is a classic flaw associated with what is known as the "infant industry" Often implemented in the form of tariffs to protect a fledgling domestic industry from foreign competition, the "infant industry" rationale encourages policy makers temporarily to handicap incumbents or offer preferences to their less-experienced rivals in order to boost the latter's ability to compete and overcome the alleged advantages of incumbency. There are many pitfalls associated with infant industry regulations, which cause economists, as a whole, to question their wisdom in most circumstances. [Id., p. 82]

Effective competition is a valid public policy goal, and need not be inconsistent with the goal of universal service. Nothing in my testimony suggests that I am in favor of subsidizing new entrants, or "protecting them from competition, applying rules unequally to them, or otherwise enhancing their ability to succeed beyond what the quality and costs of their own business can accomplish."

However, in this industry barriers to entry tend to be very significant -- including barriers that have been created by, or are perpetuated by, various government policies. Thus, it is reasonable and appropriate for the Commission to consider whether various policy options have the effect of either increasing or lowering those barriers. Changes in the structure of the AUSF or other policy options being considered in this proceeding can and should be evaluated with respect to whether those changes will encourage or discourage entry into the industry. For instance, policy changes which reduce the availability of revenues from access charges may have the effect of reducing the profitability and viability of competitive local exchange carriers (CLECs). Similarly, policy changes which have the effect of increasing the size of the AUSF may have the effect of increasing barriers to entry into rural markets – particularly if the AUSF continues to be effectively available only to the incumbent local exchange carriers. In recommending that AUSF funding be treated as "portable" support which follows customers, rather than carriers, so that if a customer "votes with their feet" by changing carriers, AUSF funding support would shift to the new carrier, I am recommending that the Commission should try to avoid policies which make it more difficult for new entrants to gain a foothold in the industry.

Q. Can you briefly discuss recent competitive trends in the telecommunications industry?

A. The largest single step to opening up the entire industry in general, and the local exchange market in particular, was adoption of the 1996 Telecom Act, in which Congress mandated the removal of many barriers to competitive entry. This triggered an enormous shift in the structure, and regulation, of the local exchange market. The 1996 Act established a national policy in favor of local competition, and it declares invalid all state rules that restrict entry or otherwise limit competition in telephone service. While the 1996 Act reduced legal barriers to entry, it was not as effective in removing economic barriers to entry. None of the firms with the greatest expertise in local telephony ever made any substantial effort to enter any of the local exchange markets dominated by other incumbent carriers. Like "the hound that didn't bark," this absence of significant market penetration is extremely significant, and it strongly suggests the continued presence of very substantial (albeit not highly visible) barriers to entry. If competitive entry were as easy as the large incumbent carriers often claimed, (or barriers to entry were as insubstantial as they claimed), then at least one or two of these carriers would have started to vigorously compete with each other.

Rather than realizing the vision of numerous small carriers vigorously competing with each other in each local market, we have instead seen massive industry concentration similar to that which characterized this industry from the early 1900's until the old Bell System was broken up by the AT&T divestiture. Wave after wave of mergers have been approved by regulators, consolidating many of the Regional Bell Operating Companies, numerous independent (non-Bell) local exchange carriers, once-independent long distance carriers, and many of the largest, most innovative competitive carriers. Still other small players were eliminated from the industry through various bankruptcy filings. This crescendo of mergers reached its climax when Verizon was allowed to acquire MCI and SBC was allowed to acquire AT&T. The Verizon acquisition of MCI was particularly noteworthy since MCI had previously completed a long series of mergers and acquisitions, in which it gobbled up dozens of competing long distance carriers, internet backbone carriers, and competitive local exchange carriers. As a result of these mergers, AT&T and Verizon control huge portions of the internet backbone and long distance markets, in addition to large shares of numerous wireline and wireless markets throughout the country. Yet, neither of these firms has shown much interest in competing with each other in the traditional basic local exchange market, or in the broadband internet market. The lone exception is wireless, where they do compete aggressively.

Q. What are the consequences of this industry consolidation?

A. First, this consolidation has directly and indirectly reduced competition in various markets throughout the country. Second, consolidation allowed some of the largest, most highly advantaged firms to expand and strengthen their already-dominant position within the industry, making it even harder, or impossible, for smaller firms in the industry, or new entrants, to compete with these "mega-carriers". Arguably, this long series of mergers has undone much of the benefits wrought by the 1996 Telecom Act, facilitating a trend toward a more co-operative or shared oligopoly market structure, in which a relatively small number of firms, led by Verizon and SBC, dominate specific geographic regions and market segments, while avoiding to various degrees direct, head-to-head competition in many segments. Third, many of the firms that had been aggressive, independent participants in the regulatory, legislative and judicial processes (E.g., AT&T, MCI, WorldCom, Metropolitan Fiber and other firms that were acquired by MCI) are no longer providing an effective counterbalance to the advocacy efforts of Verizon and AT&T before the FCC, state legislatures, and state regulatory bodies.

Although the consolidation hasn't been as extreme in the wireless industry, the FCC and other policy makers have also authorized a massive consolidation of that part of the industry. Federal officials initiated a policy of widely disbursed spectrum licenses, which initially encouraged dozens of new entrants into the industry, and ensured that that nearly every major metropolitan market had half a dozen competing carriers – including some smaller local and regional carriers. Policy makers subsequently approved a series of mergers and acquisitions which allowed large amounts of spectrum to be concentrated into the hands of a small number of firms that face each other in numerous markets throughout the nation – AT&T, Verizon, T-Mobile, and Sprint-Nextel.

Q. What about the cable companies? Doesn't their entry into the telecommunications markets indicate some level of competition?

A. Yes. Cable companies, with their vast networks, are uniquely situated and are an important part of the overall competitive picture. However, their success is based upon some unique circumstances, and not simply the result of reduced barriers to entry. In fact, during the Triennial Review proceedings earlier this decade, the FCC placed little weight on evidence concerning telephony services provided over cable television facilities when analyzing barriers to entry. For example, the FCC stated that a cable company providing local phone service "provides no evidence that competitors have successfully self-deployed switches as a means to access the incumbents' local loops, and have overcome the difficulties inherent in the hot cut process". [FCC Triennial Review Order, ¶440]

While government policy has often been designed to encourage entry and effective competition, not all policy decisions have worked out as intended or expected. As this brief historical review makes clear, there is good reason to be concerned about the "unintended consequences" of policy changes. I want to be clear that I am not proposing an "infant industry" approach, which would subsidize inefficient firms, or skew things in favor of smaller carriers and against the largest firms. Rather, I am simply suggesting that the Commission ought to think carefully about the potential impact of alternative policy options that are before it. In evaluating the pros and cons of various policy alternatives, the Commission should be cognizant of the potential impact of those alternatives on the policy goal of encouraging effective competition, and it needs to think carefully about the potential effects of its actions – before implementing drastic changes to existing industry arrangements. Otherwise, changes that are intended to solve problems in one area may result in worse problems in another area. The Commission should try to avoid increasing barriers to entry, and it should try to take proactive steps to design policies which do not favor larger firms over smaller ones, or favor incumbent firms over new entrants – thereby advancing effective competition as one aspect of its public policy decisions.

Q. Can you now turn to the reply testimony of ALECA? What issues do you intend to address?

A. I would like to briefly respond to ALECA witness Douglas Meredeth's comments regarding cost trends in the telecommunications industry, and his comments regarding unregulated activities and revenues. With regard to the first issue, Mr. Meredith states:

> Although switching costs have fallen with technological advances, the costs of placing aerial and buried cable and constructing outside plant structures have increased. Because of lower population densities, cable and plant costs are also proportionately higher for ALECA's members. One mile of cable could serve hundreds if not thousands of customer [Sic.] in Qwest's urban areas. By contrast, one mile of cable may well serve far fewer than a hundred customers, even as few as one customer per mile. Dr. Johnson also ignores how competition is eroding revenues. Like similar incumbent LECs all across the country, ALECA member companies have lost access lines to competitors (e.g., wireless carriers and VoIP service providers). At the same time, the high fixed costs of local telephone service in a specific geography have not fallen as quickly (if at all) as line losses, thereby tending to raise the cost of access per line. [Meredith Reply, p. 10]

I do not dispute the fact that costs are higher than average in rural areas where there are relatively few customers per mile of cable. However, this testimony doesn't really address the point I was making, which is that there have been favorable downward cost trends in the industry which should not be ignored. Unlike many sectors of the economy, in the telecommunication industry the cost of many services has declined over time. In more recent years, one of the most important ways this phenomena has been seen is in the ability to spread the cost of utility poles and other fixed plant investment across both voice and data traffic. As internet traffic has grown, the effective cost per unit of information communicated has continued to decline sharply over time. These cost trends should facilitate a downward trend in costs for the ALECA members.

The ability to use local network facilities for both voice and data purposes has greatly reduced the "real"cost of voice traffic – although the impact of this favorable trend isn't necessarily fully reflected in the cost data reported for intrastate regulatory purposes, which doesn't necessarily reflect the full impact of increasing volumes of data traffic. Whether an incumbent LEC's "actual" costs of voice traffic have been increasing or decreasing over time will depend in part upon how successfully it has responded to changing technological and economic conditions. In this regard, it is important to realize that outcome of these trends in the future may depend, in part, on the regulatory policies and incentives adopted by this Commission. For instance, if the AUSF were to be greatly expanded, structured in a manner which makes it exclusively available to the incumbent LECs, this may largely insulate them from pressures to operate as efficiently as possible, to adopt cost-effective new technologies, and to improve their work processes. An expanded AUSF, which is not competitively neutral would make life easier for the owners and managers of the ALECA member firms, but it would not advance the public interest. A sound approach to the AUSF will provide encouragement and incentives for the incumbent LECs to cut their costs as much as possible, and to continually increase their efficiency. Even if there is little actual competitive entry into rural markets, the threat of potential entry may be an important force pressuring these firms to control their costs, and take full advantage of favorable technological trends, thereby ensuring that the AUSF does not place an undue burden on urban customers.

Taken to the extreme, a poorly designed high cost support system, would provide the incumbent LECs with guaranteed 100% recovery of their "actual" costs, no matter how high, and allow them to indefinitely preserve any excess profits they may currently be generating, while protecting them from competition, by ensuring that no other firms are allowed to draw from the AUSF. Even worse, such a poorly designed policy would require retail customers in urban areas to provide these carriers with full compensation for any lost revenue or margin which these firms experience when customers reduce their reliance on traditional wireline service or increase their use of wireless and broadband communications. Clearly, a properly designed AUSF should not insulate these firms from the pressures that encourage a typical competitive firm to operate as efficiently as possible, nor should it guarantee these firms will continue to receive their existing level of revenues and profits, regardless of how high their current profits, or how little effort they make to control their costs.

Q. Finally, can you respond to Mr. Meredith's comments regarding unregulated activities?

A. In my direct testimony, I recommended the Commission look closely at how the unregulated services affected the share of network cost borne by regulated intrastate services. Mr. Meredith replied:

> [T]he FCC has prescribed elaborate rules for allocating incumbent LEC's accounting costs between regulated and unregulated activities. 20 CFR 64. ALECA's member companies participating in these proceedings, all comply with FCC rules. Therefore all nonregulated activities of the ALECA members have already been removed and should not be a factor in this proceeding. [Id., p. 11]

I don't find this argument persuasive in the least. The Commission should look into this issue closely. It should not ignore this issue, or assume the FCC's rules are adequate to deal with the issues that are relevant to this proceeding, or to assume that this Commission has no say in determining the appropriate allocation of costs for intrastate jurisdictional purposes – particularly in the context of a fair value rate base analysis, or to assume that there are no ambiguities, or room for interpretation of those rules. A cavalier dismissal of this important issue is particularly inappropriate when coupled with the ALECA members' opposition to any form of rate case or regulatory review of their existing earnings.

Some parties are arguing that AUSF increases can appropriately be authorized without looking closely at the earnings of carriers or the impact of growth in internet access and other non-jurisdictional services. AUSF (or local rate) increases should not be approved merely because the rate changes would be "revenue neutral." A policy of "revenue neutrality" is appealing to carriers, since it protects them from adverse changes in their revenues, but it is not fair to customers. Revenue neutrality fails to protect customers from bill increases, it fails to ensure that the public interest is protected, and it is not a sufficient basis for waiving the requirement that rate changes be accomplished in the context of appropriate findings concerning fair return on fair value.

Preferably, the Commission would consider reductions in access charges in conjunction with individual rate case proceedings, which would allow the Commission to closely examine all of these issues, including the appropriate allocation of shared network costs to internet access and other non-regulated services. However, if the Commission were to conclude that individual rate proceedings would impose too large an administrative burden, and are not legally required, then it should at least probe into these issues in the context of a future phase of this proceeding, after collected detailed accounting information from the carriers and providing an ample opportunity for the parties to conduct detailed discovery concerning that information. Detailed, carrier-specific fact finding investigation is needed, to ensure that urban customers are not required to make higher than necessary payments into the AUSF. As part of this on going investigation, the Commission should look closely at the appropriate allocation of loop costs and other shared network costs to internet access and other unregulated services.

Q. Does this complete your rejoinder testimony, which was prefiled on March 5, 2010?

A. Yes, it does.